IN THE

Supreme Court of the United States

October Term, 1976

No. 75-1019

BOSTON STOCK EXCHANGE, CINCINNATI STOCK EXCHANGE, DETROIT STOCK EXCHANGE, MIDWEST STOCK EXCHANGE, INCORPORATED, PACIFIC COAST STOCK EXCHANGE, and PBW STOCK EXCHANGE, INC.,

Plaintiffs-Appellants

v.

STATE TAX COMMISSION, NORMAN GALLMAN, MILTON KOERNER, and A. BRUCE MANLEY, as members of the State Tax Commission of the State of New York,

Defendants-Appellees

On Appeal From The State of New York Court of Appeals

REPLY BRIEF FOR THE APPELLANTS

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I. REPLY TO DEFENDANTS' STATEMENT OF THE CASE

A. Defendants' Misstatement of the Question Presented

Defendants assert that section 270-a does no more than impose a tax on certain sales made within New York State. From this premise they argue that the only question presented by plaintiffs' challenge of section 270-a is the constitutionality of New York's establishing (1) a lower tax

on sales by non-residents than by residents, and (2) a maximum tax on sales by anyone. Defendants' Brief at 2. Defendants' analysis, however, is based on a false premise.

Section 270-a does not impose a tax on sales; indeed it does not impose a tax on anything. Rather, the section effects a reduction in the rate of tax assessed against certain types of transactions otherwise subject to tax, *viz.*, transactions involving in-state sales by non-residents and in-state sales of large blocks of securities by anyone. The question presented in this case, therefore, is not whether New York has jurisdiction to tax sales of securities occurring in New York—it clearly can and plaintiffs have never suggested it cannot[1]—but whether the taxation of transactions involving in-state sales at the lower tax rates specified in section 270-a discriminates against interstate commerce when identical transactions involving out-of-state sales are taxed at a higher rate. In light of defendants' mischaracterization of the tax, a somewhat more detailed explanation of the operation of the tax than is contained in plaintiffs' brief may serve to highlight its discriminatory impact and sharpen the constitutional issue presented.

The only section of New York's "Tax on Transfers of Stock and Other Corporate Certificates", New York Tax Law, art. 12 (McKinney 1966, as amended), that imposes

[1] Defendants' frequent assertions of a "sufficient local nexus" to sustain the transfer tax, Defendants' Brief at 2, 14, 16, and 17, further reveal their misunderstanding of the issue presented. Plaintiffs do not challenge New York's power to tax sales, transfers, or deliveries that occur in New York. What they do challenge is New York's right under the commerce clause to structure the rates of taxation assessed against those events for the purpose and with the effect of discriminating against out-of-state stock exchanges in their competition with in-state stock exchanges.

a tax is section 270.1.[2] That section imposes a tax on all sales, agreements to sell, memoranda of sales, deliveries, and transfers of securities. The occurrence of any one of those events in New York State creates what defendants' own Rules and Regulations refer to as a "taxable transaction." *See, e.g.,* Rules and Regulations of the State of New York, tit. 20, §§ 440.1(i) and 447.1(a)(1962, as amended); 2 CCH *State Tax Rep., N.Y.* ¶¶ 57-102 and 57-104—57-130. For purposes of determining the amount of tax due, the taxable transaction looked at as a whole, not the separate events that it comprises, is the relevant unit.[3] As the Rules and Regulations state:

> "The fact that two or more of the taxable events . . . occur within the State of New York with respect to a single transaction does not mean that more than

[2] "There is hereby imposed and shall immediately accrue and be collected a tax, as herein provided, on all sales, or agreements to sell, or memoranda of sales and all deliveries or transfers of shares or certificates of stock, or certificates of rights to stock, or certificates of interest in property or accumulations, or certificates of deposit representing certificates taxable under this article, in any domestic or foreign association, company or corporation, or certificates of interest in business conducted by a trustee or trustees, made after the first day of June, nineteen hundred five, whether made upon or shown by the books of the association, company, corporation, or trustee, or by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of sale or transfer, whether intermediate or final, and whether investing the holder with the beneficial interest in or legal title to said stock, or other certificates taxable hereunder, or merely with the possession or use thereof for any purpose, or to secure the future payment of money, or the future transfer of any such stock, or certificates." New York Tax Law § 270.1 (McKinney Supp.).

[3] Thus, defendants are incorrect when they assert, "The sole question is the constitutionality of the tax as applied in New York tc transactions occurring there and nowhere else." Defendants' Brief at 20. Taxable transactions may involve events such as sales, occurring outside of New York. *See, e.g.,* Rules and Regulations, tit. 20 § 440.1; 2 CCH *State Tax Rep., N.Y.* ¶¶ 57-102—57-130. Indeed, section 270.2 prescribes different rates of tax for taxable transactions depending upon whether they involve a sale, regardless of whether the sale occurs in-state or out-of-state. *See* note 4, *infra.*

one tax is imposed; only one tax is payable with respect to any one transaction. Thus, if a sale, delivery of the certificates and record transfer to the name of the purchaser are all made within the State, only one tax is payable. However, if any one of these taxable events occurs within the State with reference to any transaction, it is subject to tax regardless of where the others occurred. Thus, a transfer of record ownership on the books of the corporation within the State is subject to tax, even though the sale and delivery of certificates were made outside the State. The same is true of a sale or agreement to sell, or a delivery of certificates made within the State, although all other events relating to the same transaction occurred without the State." Rules and Regulations, tit. 20, § 440.2; 2 CCH *State Tax Rep., N.Y.*, ¶ 57-102c.

The rate of tax to be assessed against any particular taxable transaction is prescribed by either section 270.2 or section 270-a[4]. Section 270.2 applies to all taxable transactions other than those specifically described in section 270-a, *i.e.*, in-state sales by non-residents and in-state block sales by residents and non-residents. Accordingly, regardless of whatever other characteristics may be present, a taxable transaction by a non-resident or one involving a block of stock is subject to the higher rate of tax in section 270.2 if there is an out-of-state sale and to the lower rate of tax in section 270-a if there is an in-state sale.

The discriminatory operation of the alternative rates of tax in section 270.2 and section 270-a is clearly explained by defendants' own tax counsel in an opinion which defandants reprint as Appendix B to their brief. The opinion illustrates the different taxation of identical transactions by nonresidents with the following examples:

"(1) X, a nonresident of the State of New York (as defined in paragraph (b) of subdivision 1 of section 270-a), sells shares of stocks through his broker on a securities exchange located outside of the State of New York. The stocks are sent to a transfer agent in the State of New York to effectuate the record transfer of the stock to the name of the purchaser. The record transfer of the shares made by the transfer agent in New York State is subject to the rate of tax prescribed by subdivision 2 of section 270 of the Tax Law, rather than the lower tax prescribed by paragraph (a) of subdivision 1 of section 270-a *as the sale was not made in the State of New York.*

"(2) X, a nonresident of the State of New York, sells shares of stocks through his broker on a securities exchange located in the State of New York. The stocks are sent to a transfer agent in the State of New York to effectuate the record transfer of the stocks to the name of the purchaser. The sale of the stocks having been made *in the State of New York* by a nonresident

[4] Section 270.2 states:

"Except as otherwise provided by section two hundred seventy-a of this chapter, the tax imposed by this section shall be two and one-half cents for each share, except in cases where the shares or certificates are sold, in which cases the tax shall be at the rate of one and one-quarter cents for each share where the selling price is less than five dollars per share; two and one-half cents for each share where the selling price is five dollars or more per share and less than ten dollars per share; three and three-quarters cents for each share where the selling price is ten dollars or more per share and less than twenty dollars per share and five cents for each share where the selling price is twenty dollars or more per share." New York Tax Law § 270.2 (McKinney Supp.)

The flat two and one-half cents per share rate is imposed only on transactions not involving a sale, *e.g.*, a gift. Rules and Regulations of the State of New York, tit. 20, § 441.1(2) (1962, as amended); 2 CCH *State Tax Rep., N.Y.* ¶ 57-404. When a taxable transaction involves a sale (whether in-state or out-of-state), the rate of tax set by section 270.2 depends on the selling price. Rules and Regulations, tit. 20, § 440.1(1); 2 CCH *State Tax Rep., N.Y.* ¶ 57-404. The rate of tax set by section 270.2 is modified by the "non-resident discount" and "maximum tax" of section 270-a. (App. 14-21.) Rules and Regulations, tit. 20, § 441.2(a) and (f); 2 CCH *State Tax Rep., N.Y.*, ¶ 57-401c. A surcharge of 25% is imposed on the rate of tax prescribed by both section 270.2 and section 270-a. New York Tax Law § 270-d (McKinney Supp.)

the lower rate of tax prescribed by section 270-a is applicable." Defendants' Brief at 27-28 (emphasis added).

Absent the overlay of section 270-a, the tax scheme established by section 270.1 and section 270.2 would be unobjectionable under the commerce clause, *Hatch* v. *Reardon,* 204 U.S. 152 (1907), for it would impose equal tax burdens on all persons effecting taxable transactions with respect to the same number of securities at the same price. *See Henneford* v. *Silas Mason Co.,* 300 U.S. 577 (1937). The effect of section 270-a, however, is to create alternative rates of tax, a higher and a lower, for identical taxable transactions keyed solely to whether the sales involved in those transactions occurred inside or outside of New York.[5] These alternative tax rates were designed to, and do in fact, place plaintiffs at a significant disadvantage in their competition with stock exchanges located in New York. The question presented in this case, therefore, is whether New York can structure its tax on securities transactions for the purpose and with the effect of discriminating against out-of-state businesses.

B. Defendants' Misstatement of the Impact of Section 28(d) of the Securities Exchange Act of 1934.

On page 4 of their brief, plaintiffs state:

> "Thus a person transferring or delivering securities in New York pursuant to an out-of-state sale now [*i.e.,* by reason of section 270-a] pays a higher tax in many circumstances than one transferring or delivering the same securities pursuant to an in-state sale."

[5] Footnote 9 in plaintiffs' brief discussing the graph on page 9 is not "incorrect" as defendants assert, Defendants' Brief at 9, but a precise description of the operation of section 270-a in the circumstances not represented on the graph. To change the footnote as defendants suggest would misstate the operations of the non-resident discount. New York Tax Law § 270-a.1 (McKinney Supp.).

Defendants claim that this statement "no longer holds true" but is "now moot and is no longer involved . . . ." Defendants' Brief at 8. Defendants thus concede that the statement used to be true, but assert that it is now "inaccurate" because of the addition of section 28(d) to the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(d) [hereinafter cited as section 28(d)] by the Securities Acts Amendments of 1975, Pub.L.No. 94-29 (June 4, 1975).

Defendants' attempt to use section 28(d) to blunt the discriminatory operation of section 270-a is misguided. Section 28(d) merely removes New York's power to tax:

> ". . . any [1] change in beneficial or record ownership of securities effected through the facilities of a registered clearing agency or registered transfer agent . . . or . . . [2] delivery or transfer of securities to or through or receipt from such agency or agent . . . ."

In all other respects, New York's transfer tax, including section 270-a, remains as it was before the enactment of Pub.L.No. 94-29 (June 4, 1975). Therefore, as counsel to the New York State Department of Taxation and Finance recognizes in reference to section 28(d), ". . . where a sale, agreement to sell, memorandum of sale or *any other delivery or transfer* takes place in New York State, the stock transfer tax due and owing thereon must be paid." Quoted in Defendants' Brief at 9 (emphasis added).

Thus, according to defendants' own tax counsel, taking full account of section 28(d), a person transferring or delivering securities in New York pursuant to an out-of-state sale pays a higher tax in many circumstances than one transferring or delivering the same securities in New York pursuant to an in-state sale. Examples of such circumstances include the following:

1. Many institutional investors domiciled in New York chose, for reasons of policy or to minimize legal liability, to take possession of all securities they own. *Cf.* New York State Insurance Department Circular Letter No. 1 (1975). With respect to such investors, a tax will be imposed each time they purchase securities irrespective of whether the transfer is effected through a registered transfer agent or registered clearing agency. Significantly, however, if a block of stock is purchased out-of-state the tax will be higher (*i.e.*, calculated in accordance with section 270.2) than it will be if the same block is purchased in-state (*i.e.*, the tax will be calculated in accordance with section 270-a).

2. Any time a non-resident sells to a resident and the resident takes delivery in New York, the rate of tax assessed against the transaction will depend on the place of sale: a higher rate for an out-of-state sale and a lower rate for an in-state sale. This result is unaffected by any role that may be played in the transaction by a registered transfer agent or registered clearing agency.

3. For a block transaction or a transaction involving a sale by a non-resident, if transfer occurs in New York through someone other than a registered transfer agent or registered clearing agency, *see* Securities Exchange Act of 1934, § 17A(c)(1), 15 U.S.C. § 78q-1(c)(1), the place of sale will determine whether the higher or lower tax rate is assessed against the transaction.

Defendants state that "... the significance of [section 28(d)] to the issue involved is overlooked and incomplete." Defendants' Brief at 10. But the significance of section 28(d) was discussed fully by plaintiffs in the first document they filed in this Court, (Appendix G to Jurisdictional Statement) and defendants fail to mention a single respect in which plaintiffs' discussion of section 28(d) is incomplete. Clearly section 28(d) limits the application of New York's transfer tax in certain situations, but this limitation affects

neither the constitutional issue raised in this case nor this Court's jurisdiction.

II. REPLY TO DEFENDANTS' ARGUMENT

A. The Protection of New York State's "Economic Interests" Is Not a Justification for Discriminating Against Interstate Commerce.

Defendants argue that section 270-a is constitutional because its purpose is "to protect [New York's] economic interests, [New York's] public revenue, a major [New York] industry, and the economic welfare of [New York's] citizens dependent thereon." Defendants' Brief at 10. This bald acknowledgment of discrimination against interstate commerce in favor of parochial state interests is a confession of the statute's constitutional invalidity. *See* cases cited and discussed in Plaintiffs' Brief at 11-15.[6]

This Court stated last term:

> "[It is] well established by the history of the Commerce Clause, that this Nation is a common market in which state lines cannot be made barriers to the free flow of both raw materials and finished goods in response to the economic laws of supply and demand." *Hughes* v. *Alexandria Scrap Corporation*, No. 74-1607 (June 24, 1976).[7]

See also, Great Atlantic & Pacific Tea Co., Inc. v. *Cottrell*, 424 U.S. 366 (1976). New York's attempt to use section 270-a to "... minimize the competitive problems for New York securities markets ..." (App. 27.) is an effort to turn this nation's "common market" for securities transactions

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[6] Defendants' attempt to distinguish plaintiffs' authorities is merely a repetition of the arguments in their Motion to Dismiss. The inaptness of defendants' arguments is discussed in Plaintiffs' Brief in Opposition to Motion to Dismiss at 4-5.

[7] Unlike *Hughes*, this case involves no "... commerce which owes its existence to a state subsidy program." Stevens, J. concurring.

into a series ". . . of preferential trade areas destructive of the very purpose of the Commerce Clause." *Dean Milk Co.* v. *Madison,* 340 U.S. 349, 356 (1951).

Defendants' reliance on the legislative objectives of the Securities Acts Amendments of 1975, Pub.L.No. 94-29 (June 4, 1975) (the "1975 Amendments") to justify section 270-a is misplaced. *See* Defendants' Brief at 10-12. It is one thing for the nation as a whole to attempt to strengthen its securities markets ". . . to assure that the country maintains a strong, effective and efficient capital raising and capital allocating system in the years ahead." Conference Report, Securities Acts Amendments of 1975, H.R.Rep.No. 94-29, 94th Cong., 1st Sess. 91 (1975). It is quite another for New York to attempt to ". . . provide long-term relief from some of the competitive pressures [on New York exchanges] from outside the State." Governor's Memorandum on Approval of section 270-a (App. 24). The latter effort is inconsistent with the former for its success would ". . . place the trade and business of the country at the mercy of local regulations, having for their object to secure exclusive benefits to the citizens and products of particular States." *Guy* v. *Baltimore,* 100 U.S. 434, 442 (1880).

The 1975 Amendments seek ". . . to enhance competition and to allow economic forces, interacting within a fair regulatory field, to arrive at appropriate variations in practices and services." S.Rep.No. 94-75, 94th Cong., 1st Sess. 8 (1975). Section 270-a seeks to restrain competition between New York exchanges and out-of-state exchanges.[8] Thus,

[8] Relief from national competition was the most prevalent theme in the legislative history of section 270-a. The Governor observed that "competition for the New York markets has been heightened by the rise of regional stock exchanges located outside the State", and noted, "[t]he development of modern telecommunications and electronic computer systems has, of course, greatly expanded the capacity of the regional exchanges to challenge the New York exchanges for business" (App. 23-24); the President of the New York

rather than New York's legislative objectives being "no different from those national objectives which Congress recognize [*sic*] with the enactment of [the 1975 Amendments]", Defendants' Brief at 10, those objectives are in direct conflict with the federal objectives—and with the clear purpose of the commerce clause:

> "[A] state consistently with the commerce clause cannot put a barrier around its borders to bar out trade from other states and thus bring to naught the great constitutional purpose of the fathers in giving to Congress the power 'To regulate Commerce with foreign Nations, and among the several States . . . .' Nor may the prohibition be accomplished in the guise of taxation which produces the excluding or discriminatory effect." *Nippert* v. *City of Richmond,* 327 U.S. 416, 425 (1946).

At the heart of the commerce clause is a prohibition against a state using its taxing power to protect local businesses from competition from businesses in other states of the United States. To enforce this prohibition, the Court has "viewed with particular suspicion state statutes requiring business operations to be performed in the home State that could be more efficiently performed elsewhere. Even where the state is pursuing a clearly legitimate local interest, this particular burden on commerce has been declared to be virtually *per se* illegal." *Pike* v. *Bruce Church, Inc.,* 397 U.S. 137, 145 (1970). Here New York is requiring, through economic coercion, that securities be sold in New York though better or equal prices are available elsewhere. There is no legitimate interest at stake, only New York's bald attempt to protect its local securities industry from

Stock Exchange expressed concern regarding ". . . increasing competitive problems in recent years from regional stock exchanges located in San Francisco, Los Angeles, Chicago, Detroit, Philadelphia and Boston" (App. 26); and the legislature acknowledged that it was reacting to what it characterized as ". . . the diversion of business to those [out-of-state] exchanges" (App. 14).

pressures of interstate competition. The commerce clause clearly prohibits such action.

B. Section 270-a Is Not "In Favor" of Interstate Commerce.

The defendants argue in their brief, as they did in their Motion to Dismiss, that section 270-a is constitutional because it is designed "in *favor* of [interstate commerce] by encouraging the occurrence of stock transactions involving non-residents in the State of New York." Defendants' Brief at 16.[9] There is no question that section 270-a "encourages" non-residents to trade securities in New York—that is one of the reasons for this law suit. But rather than doing so in a manner "in favor of interstate commerce", it does so by discriminatory taxation of transactions involving out-of-state sales.

Everything else being equal, if New York imposes a tax on sales of securities, an investor will be "discouraged", or have a disincentive, from selling securities in the state. This disincentive to trade in New York because of the transfer tax is referred to by the New York Court of Appeals and defendants as plaintiffs' "position of economic superiority" under the transfer tax as it operated prior to the enactment of section 270-a. (App. 34; Defendants' Brief at 19.) Whether the transfer tax is viewed as a disincentive to trade in New York or an economic advantage for exchanges in other states, New York could eliminate the "disincentive" or "economic advantage" by simply eliminating the tax. So long as the tax remains, however, the commerce clause prohibits New York from imposing restrictions on

[9] Defendants do not suggest that the maximum tax provision as it affects New York residents is "in favor of" interstate commerce. Quite the contrary is the case, of course, for section 270-a operates to make it more expensive for a resident to sell a block of securities out-of-state than in-state. Plaintiff's Brief at 17-23.

interstate commerce designed to "neutralize" the "economic advantages" the tax confers on out-of-state exchanges. *Baldwin* v. *G.A.F. Seelig, Inc.,* 294 U.S. 511, 528 (1935); Plaintiffs' Brief at 20-23.

The "encouragement" section 270-a provides for non-residents to sell securities in New York has nothing to do with favoring interstate commerce. The out-of-state investor who is "encouraged" to trade in New York is already "in" New York because of the transfer or delivery element of his transaction. Through section 270-a, the State of New York, in effect, says to such an investor, "You are going to be taxed regardless of where you sell, but if you choose to sell any place but here, we will tax you at least twice as much as we would otherwise." Such "encouragement" is no more constitutional here than it was in *Halliburton Oil Well Co.* v. *Reily,* 373 U.S. 64 (1963) (out-of-state manufacturers "encouraged" to locate manufacturing plants in Louisiana to obtain lower tax rates); or in *Dean Milk Co.* v. *Madison,* 340 U.S. 349 (1951) (out-of-state milk bottlers "encouraged" to bottle milk in Wisconsin in order to sell to Wisconsin residents); or in *Foster-Fountain Packing Co.* v. *Haydel,* 278 U.S. 1 (1928) (Mississippi corporation "encouraged" to perform certain operations in Louisiana in order to ship shrimp out of Louisiana); or in *Memphis Steam Laundry Cleaner* v. *Stone,* 342 U.S. 389 (1952) (out-of-state laundries "encouraged" to locate in Mississippi in order to avoid a tax on non-Mississippi laundries soliciting business in Mississippi).

The difference between New York's former tax scheme, which plaintiffs do not challenge and which this Court has found to be consistent with the commerce clause, and that scheme as modified by section 270-a is that under the former "[e]quality is the theme that runs through all the sections of the statute." *Henneford* v. *Silas Mason Co.,* 300

U.S. 577, 583 (1937). The former tax scheme charged the same rate for all taxable transactions involving the same number of securities with the same price. That equality of treatment is missing under section 270-a, for identical transactions are now subject to different rates of tax depending upon whether the sales occur inside or outside of New York State. This discriminatory tax treatment may "encourage" non-residents to sell in New York, but precisely because it does so, it also contravenes the commerce clause.

CONCLUSION

For the reasons stated in this Reply Brief and in plaintiffs' initial Brief the judgment of the New York Court of Appeals should be reversed and section 270-a of the New York Tax Law declared unconstitutional.

Respectfully submitted,

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